Principles Of Social Security Reform
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Social Security is a hugely popular government program, and rightly so. It has provided financial independence to generations of retirees. It has lifted millions of elderly Americans out of poverty. It has developed into more than a safety net, as was originally intended. It has become a significant source of retirement income for Americans, providing approximately one-half of all retirement income in the United States to the elderly.

Yet, a growing number of younger Americans have begun to doubt the ability of the Social Security system to deliver for them. They have come to understand that the system is not an individualized retirement plan (which their parents and grandparents generations mistakenly believed the system to be), but rather the system is designed as an intergenerational transfer payment. This growing awareness has helped to move Social Security reform onto the political agenda.

This hearing, and others to follow, are vitally important. Changes in the Social Security system need to be exhaustively debated. The intellectual groundwork must be laid in order to transition to a system that offers future retirees the same sense of security experienced by current retirees. Allow me to acknowledge the work of the Cato Institute in this regard. As an advisor to their project on Social Security Privatization, I can say without reservation that Cato has been a preeminent leader in researching and articulating both the problems with the current system and possible alternatives which will enhance the well-being of tomorrow's retirees.

Mr. Chairman, in your letter of invitation, you asked that I offer my observations on the principles that should govern our approach to reforming the Social Security system. I offer seven principles for your consideration.

First, do it now. President Clinton is to be applauded for committing the nation to a thorough debate about the future of Social Security. I am excited about the several public education forums recently announced by the White House. The President's personal attention and leadership is vital to the success of any effort to modify this program. And, there is no time to waste!

Social Security reform must come sooner rather than later. Social Security's financing problem is coming much sooner than commonly believed. The key date is not 2029, the date of actuarial insolvency, but 2012, the date at which Social Security begins running an operating deficit. That is the date at which the federal government will have to find the revenue to redeem the bonds (and interest) in the Social Security Trust Fund. Where will that money come from?

There is already a $9 trillion unfunded liability in the Social Security system. Talk of trust fund balances is misleading. Trust fund surpluses are no more than a bookkeeping exercise. As a noted earlier, projections are that annual payroll tax revenues will be insufficient to pay annual Social Security benefits beginning as early as the year 2012. Beyond that date, the system will be in deficit.

The looming financial problems in the system are a consequence of the nature of the program. Under a pay-as-you-go structure, future benefits depend on a work force much larger than the retired population (or significantly higher taxes on workers who enter the system later). Until now we have studied the system through a highly favorable worker to retiree ratio and through periodic increases in the tax rate and the earnings base. Today's ratio of nearly four workers to each retiree will decline to only two workers for each retiree once the babyboom generation is fully retired.

Faced with a doubling in our retirement population by the year 2040, policymakers must begin reforms in the system now as to allow a gradual transition to a financially sensible alternative.

Second, reform must be pursued in bipartisan fashion. In his State of the Union message, Clinton properly invited all legislators, Democrat and Republican, to participate in the regional conferences that the White House will sponsor. He was also correct to suggest a bipartisan dialogue with Congressional leaders to begin shortly after the next election. The framework of a national discussion followed by concerted legislative effort is exactly the right formula. I would recommend to the White House, and to this committee, legislation currently being drafted by Representatives Stenholm and Kolbe (co-chairs of the Congressional Pension Reform Caucus) to create a "supercommittee". This bicameral and bipartisan supercommittee would develop and recommend changes in the Social Security system. Creating such a group would set the stage for quick attention to this issue at the start of the next legislative session.

Third, the Government should not invest Social Security funds but should move toward a system of Personal Retirement Accounts, which I'll elaborate on later in my testimony. Many have suggested that the government invest the Social Security surplus in real assets such as stocks, rather than government bonds as is currently done. As former Social Security Commissioner Robert Ball asks, "Why should the trust fun earn just one-third as much as common stocks?" However, allowing the federal government to become the nation's largest stockholder would undoubtedly create political problems and major problems for the U.S. economy.

Fourth, we should avoid raising payroll taxes. In 1937, when first instituted, the Old Age and Survivors insurance tax was levied at a two percent rate on only the first $3,500 of income (one percent paid by the employer, one percent as a payroll deduction). Over the past sixty years, the payroll tax has been increased on thirteen occasions. The amount of income subject to the tax, or earnings base, has been increased twenty-six times.

Further, the payroll tax is a highly regressive tax. The increase required to keep Social Security solvent- at least 50 percent would fall hardest on these least able to afford it. Today, over seventy percent of American workers pay more in payroll taxes than in income taxes. I trust more need not be said about the inadvisability of resorting to additional payroll tax hikes to sustain the system.

Fifth, the system should encourage greater savings and thereby spur economic growth. The current system, many economists believe, actually deters individual's propensity to save by giving them the illusion that Social Security is a substitute for their own personal responsibility to prepare for retirement. A survey conducted by the research group Public Agenda bears out this point. The survey found that: fully 30 percent of those aged 51 to 61 have saved less than $10,000; just 29 percent of these pre-retirees have saved more than $100,000; nearly 40 percent of those aged 33 to 5 0 have saved less than $1 0,000; and, a mere 16 percent of these babyboomers have saved more than $100,000.

A reformed system should be structured so as to increase net national savings rather than to substitute for private savings. It should also encourage the federal government to end its dis-saving policies.

Ideally, the new system should increase individuals' personal (sense of) responsibility for achieving retirement security. The current system, if anything, diminishes the sense of individual responsibility for retirement preparation. A reformed system should encourage people to do more than the required minimum.

Sixth, any changes in the system should strengthen people's confidence in retirement security. Today, many young people do not expect that Social Security will provide them with adequate, or indeed any, benefits. And many middle-aged people wonder whether they can rely on the system, on their workplace pensions, or their own savings. A reformed system should give people a sense of confidence that, provided they make a reasonable effort, they will have an adequate retirement income. A poll conducted for the Democratic Leadership Council found that among those aged 25 to 50 roughly 74 percent expressed "not very much or no" confidence in the current Social Security system. The best way to enhance confidence would be to give future retirees more control over their investment.

Accordingly, in the future the system should offer a better return on people's investment/ contribution than the current system. Even today, single men with above average incomes cannot receive back in benefits the equivalent of amounts they pay in FICA taxes during their working years. This will be increasingly true for many groups in the future. A reformed system should allow people to be confident that they will get back their money's worth on the amounts they set aside during their working years. Likewise, it should give the working poor in this country and women, who receive less in wages than men, a chance to create economic wealth for themselves and their heirs.

Under a new Social Security system, we could allow young workers the choice of diverting their Social Security taxes to privately invested accounts, similar to IRA's or 4Ol(k) plans, transforming Social Security into a mandatory defined contribution savings program. Accounts should be managed by the private sector and workers should have as much freedom to choose their investments as possible, consistent with regulations to minimize risk and speculation.

The current Social Security system penalizes working women. Social Security provides a subsidy to non-working spouses, but does so by penalizing working women. A wife is automatically entitled to 50 percent of her husband's benefits, whether or not she works. If she works, and pays Social Security taxes, she does not receive any extra benefits until she passes that 50 percent threshold. Under a system that encouraged real savings, a working woman would receive benefits based on every dollar she contributes.

The poorest 20 percent of seniors receive 81 percent of their income from Social Security. Because of privately invested Social Security system would earn higher returns and pay higher benefits, it would lift many of those seniors out of poverty.

The current Social Security system is unfair to the poor and minorities. Despite Social Security's progressive benefit formula, the program actually penalizes the poor and the ethnic minorities. The amount of benefits a person receives over a lifetime depends on how long the person lives. Because the poor generally have shorter life expectancies than the wealthy, they receive back less in life-time benefits. The same is true for African-Americans. The life expectancy of an African-American man is only 65 years and six months. As a result he will pay Social Security taxes his whole life and receive almost no benefits. The RAND Corporation concluded that Social Security transfers wealth from poor to rich, black to white, and men to women. In a private system, those who die early could pass their accumulated benefits on to their heirs. (Note: some argue that disability and survivors benefits restore Social Security's progressivity, but there are not empirical studies to support this idea.)

In this regard, any Social Security reform should allow the poor to accumulate real wealth. Middle and upper-income workers already have private investment opportunities. Allowing poor workers to divert the payroll taxes to individually-owned, privately invested accounts will allow them to accumulate real wealth and have an opportunity for ownership in America. Such a program would operate as a national ESOP plan, turning every worker into a stockholder.

The bottom line? Any reform must increase the rate of return for future workers. Social Security taxes are already so high relative to benefits that most young workers will receive a low or even negative return on their investment-less back in benefits than they pay in taxes. Most commonly discussed Social Security reforms, raising taxes or cutting benefits, would make that problem worse. While some benefit cuts may be necessary in the future-such as raising the retirement age or changing the CPI formula-those cuts should only be undertaken in the context of an overall refon-n that increases the rate of return for young workers.

Finally, a reformed system must maintain a safety net. The system should have safeguards to prevent elderly people from falling into poverty or from outliving adequate benefits. Workers should be protected in case of disability and minor children and surviving spouses should be provided for in the event of the worker's death. The current system provides those protections and a reformed system must also address these concerns.

The government should continue to guarantee a safety net in the form of a minimum benefit to all Americans. This benefit should be financed out of General Revenues or some portion of payroll taxes.

Thank you for this opportunity to address the principles of Social Security reform. I stand ready to answer any questions the committee might pose.